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No. 91-750

In the Supreme Court of the United States

OCTOBER TERM, 1991

LESTER H. KRABBENHOFT and
ANNA KRABBENHOFT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether Section 483 of the Internal Revenue Code relieves petitioners of the gift tax liability that otherwise would be imposed under Section 2512(b) for their below-market sale of real property to their children.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 939 F.2d 529. The opinion of the Tax Court (Pet. App. 16a-24a) is reported at 94 T.C. 887.

JURISDICTION

The judgment of the court of appeals was entered on June 27, 1991. A petition for rehearing and suggestion for rehearing en banc was denied on August 9, 1991 (Pet. App. 25a). The petition for a writ of certiorari was filed on November 7, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 483, 2501 and 2512 of the Internal Revenue Code (26 U.S.C.) are set forth at Appendix, *infra*, 1a-2a.

STATEMENT

1. Petitioners transferred two parcels of land to their sons on June 29, 1981. One parcel was conveyed as a gift. The other parcel was conveyed under a contract for deed with a purchase price of $400,000 to be paid in 30 annual installments, along with interest at six percent on the unpaid balance (Pet. 2; Pet. App. 2a). Petitioners filed gift tax returns reporting a gift tax liability for the donated parcel of land, but they reported no gift tax liability for the parcel conveyed by contract for deed (*ibid.*).

Section 2512(b) of the Internal Revenue Code provides that, when property is transferred for less than full consideration, "the amount by which the value of property exceeded the value of the consideration shall be deemed a gift." 26 U.S.C. 2512(b). The Commissioner issued notices of gift tax deficiency to petitioners, asserting that the difference between the value of the property they conveyed to their children by contract for deed ($443,400) and the present value of the payments due them under the contract ($252,642) constituted a gift subject to the gift tax (Pet. App. 2). The Commissioner determined the present value of the proceeds of the sale by applying an 11 percent discount rate to the payments required by the contract (*ibid.*).

2. Petitioners contested the Commissioner's determination of deficiencies in the Tax Court. They claimed that, under Section 483 of the Internal Revenue Code, the Commissioner was prohibited from valuing the payments due under the sale contract at less

than their face value. Section 483 imputes *interest income* to the seller of property under installment sales contracts when the contract provides for interest on the unpaid balance at less than the specified minimum rate of six percent (see note 2, *infra*). See 26 U.S.C. 483. Petitioners asserted that, because the interest rate specified in the contract for deed was sufficient to preclude the imputation of additional interest income to them under Section 483, the Commissioner also was precluded from treating the conveyance as a bargain sale for gift tax purposes under Section 2512(b) of the Code. In the alternative, petitioners maintained that the six percent interest rate specified in the contract for deed represented the prevailing market interest rate for installment sales of land and that the Commissioner had erred in using an 11 percent rate to calculate the present value of the deferred payments provided in the contract.

The Tax Court, in a reviewed opinion, entered decision for the Commissioner (Pet. App. 16a-24a). The court held that Section 483 applies only to imputed interest income and has no application to the valuation of property for gift tax purposes (*id.* at 20a-21a). The court also found that the Commissioner's use of an 11 percent discount rate to obtain the present value of the deferred payments was not erroneous (*id.* at 23a).

3. The court of appeals affirmed (Pet. App. 1a-15a). The court held that Section 483 does not affect the valuation of an installment sales contract for gift tax purposes, stating that "§ 483 is simply irrelevant to such a determination" (Pet. App. 10a). The court also affirmed the Tax Court's finding that petitioners failed to prove that the 11 percent discount rate used by the Commissioner to value their contract for gift tax purposes was incorrect (Pet. App. 12a).

ARGUMENT

The decision of the court of appeals is correct. Although the Seventh Circuit reached a contrary decision in *Ballard* v. *Commissioner*, 854 F.2d 185 (1988), there is no need for this Court to resolve the conflict between the circuits because the question presented in these cases has no continuing significance in view of recent amendments to the statutory scheme.

1. Section 2501(a) of the Internal Revenue Code imposes a gift tax on any transfer of property by gift. Section 2512(b) provides that, when property is transferred for less than an adequate and full consideration, the amount by which the fair market value of the property exceeds the value of the consideration received in return is deemed to be a gift. It has long been established that, in determining whether a transfer of property has effected a gift, the value of any promissory note issued as complete or partial consideration for the transfer must be taken into account at its fair market value, rather than its face value. See, *e.g.*, *Blackburn* v. *Commissioner*, 20 T.C. 204 (1953); *Estate of Berkman* v. *Commissioner*, 38 T.C.M. (CCH) 183 (1979); cf. *Mason v. United States*, 513 F.2d 25 (7th Cir. 1975).

In the present case, petitioners transferred real property worth approximately $400,000 to their sons, in exchange for their sons' agreement to pay them $400,000 in equal annual installments over a period of 30 years, along with interest at six percent on the unpaid balance. The Commissioner determined that the prevailing interest rate on similar transactions at the time petitioners conveyed the property was 11 percent and that, consequently, the present value of the deferred payments due petitioners under the installment sales contract was approximately $250,000.

The Commissioner concluded that petitioners had made a taxable gift to their children of the amount by which the value of the property transferred exceeded the present value of the deferred payments due under the sales contract.[1]

2. Although petitioners contended that the Commissioner was required by Section 483 of the Code to treat the face value of the deferred payments under the contract as the present value of those payments, the courts below correctly held that Section 483 has no application in determining the value of consideration for gift tax purposes under Section 2512(b) of the Code.

Section 483 was enacted in 1964 to curb a specific income tax avoidance problem. Prior to the enactment of Section 483, if the parties to a contract for the installment sale of a capital asset did not expressly provide for interest to be included in the deferred payments, the seller could treat the entire amount received (to the extent it exceeded his adjusted basis in the property) as capital gain, even though part of that amount represented interest income on deferred payments of principal. In this manner, interest income (taxable at higher ordinary income rates) was converted into capital gains (taxed at lower rates applicable to that type of income). Section 483 was enacted to prevent this specific manipulation of the income tax laws. See H.R. Rep. No. 749, 88th Cong., 1st Sess. 72 (1963); S. Rep. No. 830, 88th Cong., 2d Sess. 102 (1964).

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[1] The court of appeals and the Tax Court agreed that the Commissioner's use of an 11 percent interest rate to determine the present value of the deferred payments was proper (Pet. App. 12a, 23a). Petitioners do not seek review of this issue.

Section 483 solved this problem by providing, in general, that (i) if property is sold on an installment basis with part or all of the payments due more than one year after the date of the sale and (ii) there is no provision for interest on the deferred payments, or a provision for interest that is less than the specified minimum rate (the so-called "safe harbor" rate specified in the regulations), then an allocated part of each installment is to be treated as interest income rather than as part of the sales price. The specified minimum rate applicable under Section 483 in 1981 was six percent. 26 C.F.R. 1.483-1(g) (1981).

As the Tax Court and the Eighth Circuit correctly recognized, the fact that petitioners' contract for sale provided for interest on the deferred payments at six percent did not preclude the Commissioner from determining that petitioners had made a taxable gift under Section 2512(b) of the amount by which the value of the property conveyed exceeded the present value of the deferred payments due under the contract. Petitioners' use of the safe harbor rate of six percent served only to immunize them from the imputation of additional *interest income* under Section 483. It did not protect them from gift tax liability under the separate provisions of Section 2512 of the Code.[2]

3. In reaching the contrary conclusion in *Ballard* v. *Commissioner*, 854 F.2d at 188, the Seventh Cir-

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[2] This is evident from the language, as well as the history, of Section 483. The statute applies only to installment contracts that contain "total unstated interest." Section 483 (c)(1). A contract that provides for interest at or above the "safe harbor" rate established in the regulations, as did petitioners' contract, contains no "unstated interest" within the meaning of Section 483. It is therefore not subject to the provisions of that statute. See 26 U.S.C. 483(b), 483(c)(1).

cuit placed undue emphasis on the language in Section 483(a) which states that its provisions are applicable for the "purposes of this title" (26 U.S.C. 483(a)). The Seventh Circuit reasoned that because the term "title" refers to the entire Internal Revenue Code, which includes both Subtitle A (Income Taxes) and Subtitle B (Estate and Gift Taxes), Section 483 necessarily applies to gift tax calculations as well as interest income calculations. 854 F.2d at 188. As the court of appeals concluded in the present case (Pet. App. 8a), however, this reasoning "ignore[s] the simple fact that nothing in § 483 makes it relevant to valuation for gift tax purposes." Section 483 concerns imputing interest income; Section 2512(b) concerns valuation of property for gift tax purposes. There is neither a literal nor a substantive overlap between these two provisions. Moreover, nothing in the legislative history of Section 483 suggests that Congress intended that Section 483 would have any application in the gift tax area, much less that it would override the specific gift tax provisions of Section 2512(b).[3]

4. The issue presented in this case and in *Ballard* v. *Commissioner* has no continuing significance to ad-

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[3] Petitioners point to Section 483(g)—which provides a lower "safe harbor" interest rate for transfers of land between related parties—as evidence that Congress intended to protect the type of transaction at issue in this case from "adverse gift tax consequences" (Pet. App. 8). Nothing in Section 483(g) or its legislative history supports that reading. Section 483(g) was intended to provide *income tax* relief to individuals selling land to related parties, because Congress believed that it is unlikely that interest rates would be understated in land sales since a *buyer* would ordinarily prefer the payment to be deductible as interest rather than be capitalized as an overstated investment in real property. See Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 97th Cong., 2d Sess. 60 (Comm. Print 1981).

ministration of the tax laws. In the twenty-seven years that have elapsed since Section 483 was enacted, the interrelationship of Sections 483 and 2512 has been addressed in only two reported decisions. In 1984, Congress removed any lingering doubt as to the proper application of these statutes by enacting Section 7872 of the Code, 26 U.S.C. 7872.

Section 7872 provides a comprehensive scheme for the tax avoidance problems posed by the use of interest-free or below-market rate interest loans. See H.R. Rep. No. 432, 98th Cong., 2d Sess. Pt. 2, at 1370-1379 (1984); 1 S. Prt. No. 169, 98th Cong., 2d Sess. 474-485 (Comm. Print 1984). In general terms, Section 7872 provides, with respect to the gift tax, that the recipient of a loan has received a gift equal to the amount of the "foregone interest." 26 U.S.C. 7872(a). The term "foregone interest" is defined as the excess of the amount of interest that would have been payable at the applicable "Federal rate" over the amount of interest payable under the terms of the loan. 26 U.S.C. 7872(b)(2). In this statute, Congress has thus provided an objective method for valuing the gift portion of an interest free or below-market loan. At the same time, Congress established specified interest rates which, when utilized in a transaction, will preclude imposition of any additional gift tax liability.

Section 7872 codifies the approach taken by the Commissioner in this case and provides a comprehensive solution to the entire area of interest-free or below-market-rate loans.[4] In doing so, it has con-

[4] Although Section 7872(f)(8) provides that Section 7872 is not applicable to any loan to which Section 483 applies, Section 483 is applicable only to installment contracts for the sale of property that contain "total unstated interest." See

firmed that Section 483 has no application to valuations required for gift tax purposes.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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note 2, *supra*. Contracts that provide for interest at or above the safe harbor rate set forth in the regulations, as did petitioners' contract, by definition do not contain unstated interest and therefore are outside the scope of Section 483. See 26 U.S.C. 483(b) and (c)(1).

APPENDIX

26 U.S.C. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) *Amounts Constituting Interest.*—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) *Total Unstated Interest.*—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which the section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) *Payments to Which Section Applies.*—

(1) *In General.*—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

(2) *Treatment of evidence of indebtedness.*—For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

* * * * *

26 U.S.C. 2501. IMPOSITION OF TAX.

(a) *Taxable Transfers.*—

(1) *General rule.*—For the first calendar quarter of the calendar year 1971 and each calendar quarter thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar quarter by any individual, resident or nonresident.

* * * * *

26 U.S.C. 2512. VALUATION OF GIFTS.

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

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